BAD BOY GUARANTYS

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A. BACKGROUND

The term "bad boy" guaranty is used in certain circumstances to describe a guaranty to be provided - usually by an individual, not an entity - in connection with, most often, real estate financing.

The original intent of "bad boy" guarantys was to influence the post-closing behavior of a principal of the borrower, in order to discourage bad conduct that would harm the lender's position and collateral. Traditionally, the triggers for recourse to the borrower and/or guarantor liability were events such as:

- fraud
- misapplication of casualty or condemnation proceeds
- "waste" of assets
- environmental liabilities

Since the occurrence of these "bad" events was infrequent and largely within the guarantor's control, guarantors frequently agreed to the terms of the guaranty without controversy.

However, with the advent of new non-recourse financing structures designed to avoid the delay and difficulty of bankruptcy (and other litigation) - often related to the "commercial mortgage backed securities" (CMBS) market - which required the use of single asset or "special purpose entities" (SPE) and "bankruptcy remote entities" (BRE), the list of "triggers" for recourse and/or guarantor liability has grown.

B. STRUCTURE

SCENARIO 1

Typical "Limited" Guaranty Structure
(lender desires protection of "bad boy" provisions, even in a recourse loan)

1. Promissory Note from borrower to lender, contains either (a) full recourse terms or (b) non-recourse terms with exceptions for recourse events.

2. Guaranty from the "carve-out" guarantor to the lender is limited to specific triggering events or to specific types of obligations or liabilities to address the conduct and involvement of the guarantor.

SCENARIO 2

Typical Non-Recourse Guaranty Structure
(typical for CMBS loans with an SPE)

1. Promissory Note from borrower to lender, contains non-recourse terms with exceptions: events which will cause

the obligation to become recourse.

2. Guaranty from the "carve-out" guarantor to the lender, which is unconditional and unlimited, but guarantees, in some way, the recourse liability under the note.

C. TRIGGERS

The triggering events which may give rise to recourse and/or guarantor liability are often divided into two (2) groups:

Type 1. "Above-the-line" acts or recourse events which cause the lender to suffer costs, losses or expenses, the amount of which may be collected through recourse to the borrower and/or guarantor; and

Type 2. "Below-the-line" acts or recourse events which cause the borrower and/or guarantor to become liable for the full debt (or full deficiency after foreclosure), often referred to as "springing recourse", whether or not the lender experiences any loss and whether or not the borrower causes the event.

Examples of **Type 1** triggers are:

(a) fraud or intentional misrepresentation by borrower or any of certain related parties in connection with the loan;

(b) the gross negligence or willful misconduct of borrower;

(c) the removal or disposal of any portion of the collateral after an event of default;

(d) borrower's misapplication, misappropriation or conversion of rents received by borrower after the occurrence and continuance of an event of default;

(e) borrower's misapplication, misappropriation or conversion of tenant security deposits or rents collected in advance;

(f) the misapplication, misappropriation or conversion of insurance proceeds or condemnation awards;

(g) Personal Property (as defined in the security agreement) taken from the real estate collateral by or on behalf of borrower or any of certain related parties and not replaced with Personal Property of the same utility and of the same or greater value;

(h) any act of arson by borrower or any of certain related parties;

(i) any fees or commissions paid by borrower after the occurrence of an event of default to any certain related parties in violation of the terms of the loan documents;

(j) failure to pay charges for labor or materials or other charges that can create liens on any portion of the real estate collateral;

(k) any security deposits, advance deposits or any other deposits collected with respect to the real estate collateral not being delivered to lender upon a foreclosure of the real estate collateral or action in lieu thereof, except to the extent any such security deposits were applied in accordance with the terms and conditions of any of the leases;

(l) any failure by borrower to permit on-site inspections of the real estate collateral as required by the loan documents;

(m) any failure of borrower to appoint a new property manager upon the request of lender as required by the terms of the loan documents; and/or

(n) borrower's breach of, or failure to comply with, certain of the representations, warranties and covenants contained in the loan documents, such as those related to environmental and tenant matters.

Examples of **Type 2** triggers are:

(a) the first full monthly payment of principal and interest under the loan is not paid when due;

(b) borrower fails, after lapse of all applicable notice and cure periods, to provide financial information to lender as required by the loan documents;

(c) borrower fails to comply with any of the SPE and "separateness" covenants in the loan documents;

(d) borrower makes any transfer prohibited by the loan documents;

(e) borrower files a voluntary petition under the U.S. Bankruptcy Code or any other Federal or state bankruptcy or insolvency law;

(f) an affiliate, officer, director or representative which controls borrower, directly or indirectly, files, or joins in the filing of, an involuntary petition against borrower under the U.S. Bankruptcy Code or any other Federal or state bankruptcy or insolvency law, or solicits or causes to be solicited petitioning creditors for any involuntary petition against borrower from any person or entity (other than lender);

(g) borrower files an answer consenting to or otherwise acquiescing in or joining in any involuntary petition filed against it, by any other person or entity under the U.S. Bankruptcy Code or any other Federal or state bankruptcy or insolvency law, or solicits or causes to be solicited petitioning creditors for any involuntary petition from any person or entity;

(h) any affiliate, officer, director or representative which controls borrower consents to or acquiesces in or joins in an application for the appointment of a custodian, receiver, trustee, or examiner for borrower or any portion of the real estate collateral (other than in connection with any such proceeding initiated by lender);

(i) borrower makes an assignment for the benefit of creditors, or admits, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due; or

(j) entry into additional, unpermitted indebtedness.

Other "triggers" sometimes seen:

(a) the failure to discharge mechanics' liens on the project;

(b) the failure to renew insurance;

(c) the failure to repair the project;

(d) the failure to comply with leasing restrictions;

(e) the failure to pay real estate taxes;

(f) the failure to comply with ERISA;

(g) the failure to indemnify the lender in accordance with the loan documents;

(h) the failure to pay the lender certain yield maintenance payments;

(i) the failure to comply with restrictions on amending leases or accepting prepayments of rent;

(j) "misuse" of revenue from the project;

(k) any impairment or contest of any lien; and

(l) any allegation of a joint venture or partnership with a lender.

Also, it is important to observe that the "environmental indemnity agreement" utilized by many lenders is essentially a "bad boy" guaranty triggered by environmental liabilities.

D. SELECTED RECENT CASE LAW

Generally, lenders have prevailed when asking the courts to enforce properly drafted "bad boy" guarantys, on the basis that the terms are clear and have been negotiated by sophisticated parties. Courts have rejected claims that the "bad boy" guaranty is an unenforceable penalty, an invalid liquidated damage provision, a violation of public policy, good faith, fair dealing, etc. The "springing" nature of the guaranty has not been an impediment.

A number of the "triggers" have arisen as a result of court decisions in the bankruptcy waiver area. Courts have generally not enforced waivers of the right to file a bankruptcy case and waivers of rights in the bankruptcy case. As a result, ownership structures, corporate documents and "bad boy" guarantys have all come to reflect the desire to prevent and discourage bankruptcy filings, particularly in non-recourse settings.

As the "trigger" events for various degrees of recourse liability have expanded, the terms have occasionally been tested in court. The following are a few notable examples:

Wells Fargo Bank, N.A. v. Cherryland Mall Ltd P'shp, 295 Mich. App. 99, 812 N.W.2d 799 (2011) ("Cherryland I"), rev'd on remand, 300 Mich. App. 361, 835 N.W.2d 593 (2013).

In Cherryland, the guarantor executed a non-recourse guarantee under which full loan liability was triggered if the SPE covenants were violated. Among the SPE covenants agreed to by the borrower was an undertaking that the borrower would at all times remain solvent. As a result of a decline in the value of the underlying property (which was the sole collateral for the loan), the borrower was deemed insolvent. The insolvency was a breach of the SPE covenants and caused full loan liability of the guarantor under the non-recourse guaranty. This case highlights perfectly the multiple problems of (i) borrowers agreeing to SPE covenants that may have unintended consequences under the non-recourse guarantee, (ii) guarantors making themselves liable for acts and events that are out of their control, and (iii) liability under a non-recourse guarantee that is triggered without any "bad" act by either the borrower or the guarantor. This case was the impetus for the adoption of the Nonrecourse Mortgage Loan Act by Michigan.

51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., LLC, 835 F. Supp.2d 384 (E.D. Mich. 2011).

The court held that a carveout that the borrower would not "become insolvent or fail to pay its debts and liabilities" as they were due was triggered by the borrower's failure to make the full principal payment.

CP III Rincon Towers Inc. v. Cohen, No. 10-cv-04638 (DAB), slip op. at 18-34 (S.D.N.Y. Apr. 7, 2014) (Dkt. No. 103), 2014 WL 1357323.

In Cohen, a loan-to-own successor lender filed suit against a "bad boy" guarantor after foreclosing on the property. The Cohen litigation arose out of a $143 million real estate development in San Francisco secured by a $110 million nonrecourse loan and a "bad boy" guaranty from Richard D. Cohen, the borrowers' sponsor.

After refinancing with the former lender, Maiden Lane LLC, fell through, the loan was purchased by CP III Rincon

Towers Inc. for $83 million. CP III then sued the guarantor, claiming that liens filed by contractors and other creditors with disputed claims triggered three separate full-recourse carveout provisions:

(1) prohibiting any "voluntary lien encumbering the property" without written consent of lender;

(2) prohibiting any "indebtedness" in excess of $250,000 without written consent; and

(3) prohibiting "encumbrances" that were "transfers" of the collateral.

The court granted summary judgment for the defendant guarantor in one of the few post-recession decisions that reject the broad reach of earlier decisions and, importantly, took into account both the business justifications for entering into "bad boy" guaranties and the intent of the parties that drafted them to avoid a commercially unreasonable and absurd result.

E. TRENDS

1. In response to the Cherryland case in particular, both Michigan and Ohio enacted laws limiting "bad boy" provisions:

(a) Michigan: Nonrecourse Mortgage Loan Act, Senate Bill No. 992, March 2012, invalidating the use of a post-closing solvency covenant as a recourse trigger as an unfair and deceptive business practice.

(b) Ohio: Legacy Trust Act, Ohio Rev. Code Ann. 1319.07-1319.09 (2013), containing language similar to the Michigan law.

2. In some instances, "bad boy" guarantors may have succeeded in obtaining injunction protection against guaranty enforcement in the borrower's bankruptcy case pursuant to Bankruptcy Code Section 105. However, in the Eastern District of Pennsylvania, obtaining the injunction requires a showing that the guarantor can and will make a financial contribution to the reorganization of the borrower. Also, since the U.S. Supreme Court's Stern v. Marshall decision, a dispute between the lender and guarantor (absent the Section 105 injunction) will lack the jurisdiction to be heard in the bankruptcy case.

3. Other trends in regarding "bad boy" guarantys include:

(a) Increased scrutiny and negotiation - the result of some of the judicial decisions enforcing "bad boy" guarantys but gutting the non-recourse nature of the loan - including on the following points:

(i) limiting "Type 2" triggers to the most egregious acts (fraud) and not mere costs;

(ii) excluding actions by third parties, such as an involuntary bankruptcy filing, termination or breach of a lease by a tenant, and environmental problems caused by others;

(iii) notice and cure rights, such that a cured triggering event cannot cause partial or full recourse;

(iv) elimination of post-closing solvency requirements as a trigger (required in Michigan and Ohio);

(v) paring back SPE covenants, especially less critical terms, such as requirements to use separate letterhead; and

(vi) inserting greater specificity in trigger terms to require intentional acts or omissions by the borrower and/or guarantor and actual harm to the lender or its collateral (using care regarding the meaning of "voluntary").

(b) Competition among lenders will drive some reduction of the expansive language that was appearing in these guarantys. Know the deal and circumstances and focus on preventing intentional bad acts within the guarantor's control.

(c) Some borrowers/guarantors will have tax concerns about deemed taxable exchanges of debt or recognition of ordinary income upon forgiveness of recourse debt.

(d) For construction loans, guarantys of completion are often utilized, or full recourse guarantys which are curtailed upon completion. Depending upon the circumstances, these guarantys may or may not be effective. An alternative is a guaranty which requires payment of an amount equal to (1) the cost to complete less (2) the unfunded loan balance.

(e) Borrowers and guarantors will attempt to limit recourse in other ways: liability caps, allowing cures, etc.

4. UPDATE - March 7, 2016: On February 5, 2016, the Internal Revenue Service Office of Chief Counsel released its legal memorandum, Chief Counsel Advice (CCA) No. 201606027, dated October 23, 2015 and titled "Guarantee of Qualified Non-Recourse Financing" ("IRS Memo"), which related to a particular case involving an LLC that purchased and renovated hotels. The IRS Memo outlined a position where the presence in a "bad boy" guaranty of various "triggers", including specific "trigger" based on the borrower admitting its insolvency or mobility to pay its debts as they come due or making an assignment for the benefit of creditors, would cause a non-recourse loan to be recharacterized as recourse. The real estate community has expressed concern and criticism of the IRS Memo because of its potential effects on what has been standard fare in real estate financings:

(a) in the past, "bad boy" guaranty "triggers" were considered to be subject to contingencies - such as the guarantor's reluctance to cause the triggering event and become liable - which were thought to be unlikely to occur;

(b) the IRS Memo now suggests that the "bad boy" guaranty will cause the "partner" or LLC member providing the guaranty to be liable, undermining the "qualified nonrecourse financing" treatment of the loan under IRC Section 752 and the related regulations;

(c) if treated as a recourse liability, only the partner which bears risk of loss on the liability will have the tax basis and at-risk investment to claim losses in excess of its capital contribution;

(d) if retroactively applied, very substantial amounts of recapture would be faced by the non-guarantying partners/members; and

(e) it remains to be seen whether (i) the IRS Memo is reflective of a broader, developing IRS policy position and (ii) whether real estate developers, investors, lenders and their counsel are able to devise and structure workarounds. In the meantime, caution should be exercised in debt restructuring to avoid another sort of trigger: accidentally triggering an income recognition event.

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